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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

STEVE POIZNER, INSURANCE COMMISSIONER OF THE STATE OF CALIFORNIA, in his capacity as the Liquidator of Frontier Pacific Insurance Company,

Plaintiff,

v.

NATIONAL INDEMNITY COMPANY, a Nebraska corporation; and DOES 1 through 10,

Defendants.

CASE NO. 08 CV 772 L (POR)

PLAINTIFF'S OPPOSITION TO DEFENDANT'S MOTION TO STAY PROSECUTION OF ACTION PENDING ARBITRATION OF CLAIMS

[DECLARATIONS OF WILLARD ROBERTS AND LISA W. CHAO FILED CONCURRENTLY HEREWITH]

Hearing Date: August 18, 2008
Time: 10:30 a.m.
Courtroom: 14
Judge: Hon. M. James Lorenz

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I.

INTRODUCTION

Subsequent to the appointment of Plaintiff Insurance Commissioner of the State of California ("Commissioner"),[1] as Liquidator of Frontier Pacific Insurance Company ("FPIC"), Defendant National Indemnity Insurance Company ("NICO") and FPIC's parent company, Frontier Insurance Company ("Frontier"), entered into an agreement entitled Endorsement No. 3. Pursuant to that agreement, NICO agreed to not collect $40 million in unpaid premiums due to NICO from Frontier, to waive the collection of $140 million loaned to Frontier under a prior agreement and to pay Frontier an additional $50 million.

Having waived its rights to collect the $40 million from Frontier, NICO now asserts that under Endorsement No. 3, it retains the right to offset the waived $40 million against the millions it owes FPIC, subject to Frontier's ability to instruct it to release FPIC. The Commissioner disputes NICO's interpretation and brought this action to determine the effect of Endorsement No. 3. After removing this action from state court and invoking this court's jurisdiction, NICO now seeks to stay prosecution of this action pending arbitration in New York. NICO contends that the arbitration clauses in the reinsurance agreements govern the dispute over the legal effect of Endorsement No. 3 and that this action should be stayed pending arbitration.

The subject matter of this declaratory relief action is Endorsement No. 3. The Commissioner did not agree to amend the terms of the reinsurance agreement to include arbitrating his dispute with NICO regarding the interpretation and the legal effect of Endorsement No. 3. Without the Commissioner's consent to be bound by Endorsement No. 3, NICO's arguments as to why its motion for stay should be granted are unsupportable. Fundamental to NICO's ability to compel arbitration is the existence of an agreement to arbitrate the matter in dispute. The Commissioner in this action does not assert or seek enforcement of any contractual rights under any reinsurance agreement between FPIC and NICO. To the contrary, the Commissioner seeks to resolve disputes concerning the legal interpretation and the effect of an

[1] When FPIC became insolvent in 2001, Harry Low was the Commissioner. As of January 1, 2007, Steve Poizner succeeded as the Insurance Commissioner of the State of California.

agreement between NICO and Frontier, the former parent of FPIC. The Commissioner is not a party to that agreement and has no obligation to arbitrate. Moreover, NICO has not argued that the Commissioner is bound by any contractual theories that require nonparties to arbitrate.

Further, the injunctions set forth under California law and the order governing FPIC's liquidation prohibit NICO from unilaterally binding the Commissioner to arbitrate where he has not agreed to do so.[2] This dispute also is not appropriate for arbitration because it does not involve specialized terms and knowledge regarding the reinsurance industry, and the costs of arbitration are prohibitive since FPIC is already in liquidation. Finally, even if the Court finds that certain claims must be arbitrated, it may sever the arbitrable and non-arbitrable claims, and only stay those claims subject to arbitration.

Because the Commissioner is not required to arbitrate his dispute with NICO, the Court should deny NICO's request to stay this action pending arbitration.

II.

BACKGROUND

A. FPIC's Liquidation

FPIC was a California domestic insurance company that transacted insurance in California and other states. It was a wholly owned subsidiary of Frontier, a New York insurance company. *See* Declaration of Willard Roberts ("Roberts Decl."), ¶ 5.

FPIC's financial difficulties arose after its parent, Frontier, was placed into rehabilitation in the State of New York and FPIC could no longer collect the $12.8 million owed by Frontier to FPIC as its reinsurer. *Id.*, ¶ 6. On November 30, 2001, FPIC was placed into liquidation upon the order ("Liquidation Order") of the California Superior Court for the County of San Diego, in the matter entitled *Insurance Commissioner v. Frontier Pacific Insurance Company*, Case No. GIC 774028, and the Commissioner was appointed as the liquidator pursuant to California Insurance Code section 1010, et seq. *Id.*, ¶ 7 at Exhibit A, pp. 6-13.

[2] NICO concedes the existence of injunctions under the order appointing the Commissioner as liquidator of FPIC. *See* Memorandum of Points and Authorities in Support of NICO's Motion to Stay Prosecution of Action Pending Arbitration of Claims ("Motion"), pp.14-15 & fn.3.

The Commissioner has been diligently marshaling FPIC's assets and winding up its operations. The Commissioner's ability to marshal assets, however, has been thwarted by the extensive commingling of Frontier's and FPIC's accounts, their book of business and the reinsurance agreements. *Id.* at ¶ 8.

Reinsurance is normally the largest asset of an insolvent insurer. The Commissioner as liquidator has the responsibility to continue to collect reinsurance recoverables and disburse such funds primarily to the California Insurance Guarantee Association ("CIGA") to pay policyholder claims made against FPIC. As of this year, the Commissioner has completed most aspects of FPIC's insolvency proceeding, including the resolution of almost all of the claims and the collection of a substantial portion of FPIC's assets. The only significant matter that prevents the Commissioner from closing the estate and distributing assets to claimants is the collection of reinsured losses of the estate including over an estimated $28 million ultimately owed by NICO. *Id.*

B. Pre-Liquidation Reinsurance Agreements

Prior to its liquidation, FPIC and Frontier entered into three reinsurance agreements with NICO as their reinsurer. NICO assumed two of the agreements pursuant to a Novation Agreement, and entered into a third agreement directly with Frontier, which was subsequently amended to include FPIC. Roberts Decl., ¶ 9.

1. The Novated Contracts

FPIC and its parent, Frontier, were each the reinsured under the Coinsured Aggregate Excess Loss Reinsurance Agreement effective January 1, 1995, and the Aggregate Excess Loss Reinsurance Agreement effective January 1, 1998 (collective "Centre Re Agreements") with Centre Reinsurance Company of New York and its successor Zurich Reinsurance (North America), Inc. ("Zurich Re"). *Id.*, ¶ 10.

The Centre Re Agreements allowed FPIC and Frontier to withhold all of the insurance premiums due the reinsurers in a funds held account less the reinsurers' margins of 8% and 8.75% ("Centre Re Funds Held"), respectively, so that FPIC and Frontier can reimburse themselves for reinsured losses. *Id.*, ¶ 11. As of December 31, 2003, Frontier was in default under the Centre

Re Agreements and owed NICO approximately $40 million in premiums for deficiencies in the Centre Re Funds Held account. *See* Declaration of Lisa W. Chao ("Chao Decl."), Exhibit 5 at p. 45, ¶ 27.

On or about December 21, 2000, with FPIC and Frontier's consent, NICO entered into a Novation Agreement with Zurich Re which substituted NICO as the reinsurer for FPIC and Frontier. In consideration for assuming all of Zurich Re's obligations and liabilities under the Centre Re Agreements, NICO received $68,200,000 from Zurich Re. *See* Roberts Decl., ¶ 12. The novation thus released Zurich Re and its predecessor Centre Re from their obligations and responsibilities under the reinsurance agreements.[3]

2. The NICO Aggregate Reinsurance Agreement

Just prior to the Novation Agreement, on September 27, 2000, NICO and Frontier entered into an Aggregate Reinsurance Agreement, effective date of July 1, 2000 (the "NICO Agreement"). *See* Roberts Decl., ¶ 13; Declaration of Joseph Casaccio in Support of NICO's Motion to Stay Prosecution of Action Pending Arbitration of Claims ("Casaccio Decl."), Exhibit 4D at pp. 71-80. On January 5, 2001, the NICO Agreement was amended by Endorsement No. 1 to add FPIC as an additional reinsured. FPIC paid NICO a $21 million premium in consideration of NICO's agreement to pay on behalf of Frontier and FPIC up to $858,554,275 with NICO's liability to FPIC limited to a maximum of $47,089,799 for all covered losses. *See* Roberts Decl., ¶ 13; Casaccio Decl., Exhibit 4E at pp. 82-89.

Article 11 of the NICO Agreement required the written consent of all parties to amend or change the terms of the agreement as follows:

> The terms of this Reinsurance shall not be waived, modified or changed except by written amendment executed by a duly authorized officer of the Reinsurer and the Reinsured. No amendment to the Insurance Policies/Reinsurance Contracts after the Effective Date shall enlarge or alter the obligations or liabilities of the parties hereunder unless the parties have consented in writing to such amendment….

Casaccio Decl., Exhibit 4D at p. 77.

[3] Zurich Re would have remained liable to the Frontier companies jointly with NICO unless there was a novation. *See, e.g., Travelers Indemnity Co. v. Gillespie,* 50 Cal.3d 82 (1990); *Aicco, Inc. v. Insurance Co. of N. Am.*, 90 Cal.App.4th 579 (2001).

C. Subsequent Agreements Between NICO and Frontier

On August 27, 2001, Frontier was taken into temporary rehabilitation by the Superintendent of Insurance of the State of New York. *See* Chao Decl., Exhibit 5 at pp. 43-44, ¶ 20. Frontier's rehabilitation caused FPIC to be declared insolvent and conserved by the Commissioner on September 7, 2001. *See* Roberts Decl., ¶ 6.

On October 15, 2001, an Order of Rehabilitation was entered by the Supreme Court of the State of New York, County of New York ("Rehabilitation Court"), appointing the Superintendent as rehabilitator. Chao Decl., Exhibit 1 at pp. 4-8. In an attempt to work out its liquidity issues, Frontier entered into Endorsement No. 2 to the NICO Agreement with NICO. Under Endorsement No. 2, NICO was designated as an administrator to assist Frontier and loaned approximately $140 million to Frontier. Casaccio Decl., Exhibit G at pp. 91-95. FPIC was not a party to Endorsement No. 2 nor did NICO or Frontier seek the Commissioner's consent. *Id.*

Subsequently, Frontier and NICO entered into Endorsement No. 3 further amending the terms the NICO Agreement and Endorsements Nos. 1 and 2 as between NICO and Frontier. *See* Casaccio Decl., Exhibit 4H at pp. 97-102. Pursuant to Endorsement No. 3, Frontier and NICO agreed to reconcile all their account balances and all remaining obligations under the Centre Re Agreements and the NICO Agreement, including the net sums due to NICO and accrued interest thereon ("NICO Balance"). *Id.*, p. 98 at ¶ 1. In lieu of exercising its right to offset Frontier's $40 million unpaid premium obligation to fund the Centre Re Funds Held account against NICO's reinsurance obligations to Frontier, NICO agreed to pay $50 million to Frontier, less payments made to Frontier after December 31, 2003, and to release Frontier from its obligations of up to $140 million on the NICO Balance. *Id.*, p. 99 at ¶¶ 7-9. Endorsement No. 3 also reduced NICO's remaining aggregate liability limit to all reinsureds under the NICO Agreement to $225 million without affecting FPIC's sublimit.[4] *Id.*, p. 100 at ¶ 12.

[4] Despite Frontier's representation to the Rehabilitation Court that Endorsement No. 3 resolved all issues between it and NICO, NICO now asserts that Frontier continues to have an interest in the Centre Re Funds Held balance. NICO claims that to the extent it does not pay FPIC, the aggregate liability limits under the NICO Agreement will be preserved for the benefit of Frontier. *See* Motion, p. 4, fn.1.

In addition to releasing Frontier from its liability to pay $40 million in premium shortfall in the Centre Re Funds Held account to NICO, Frontier and NICO purported to shift all of Frontier's $40 million Centre Re Funds Held liability onto FPIC at the sole discretion of Frontier as follows:

> 9. With respect to the Centre Re Funds Held balance at December 31, 2003, the Reinsurer agrees not to collect this amount from Frontier as part of the $140 million of NICO Balance forgiveness referenced above, effective January 1, 2004. The Reinsurer agrees that it may only collect the remaining funds held balance from the other participants to the Centre Re Reinsurance Agreements and the Novation. In addition, Reinsurer shall abide by Reinsured's decision as to whether or not to relieve Frontier Pacific Insurance Company ("FPIC") from its obligations in respect of the funds held balance under the Centre Re Reinsurance Agreements and Novation.

Id., p. 99. NICO purportedly received a net benefit of $49,350,538 as a result of Endorsement No. 3. (*Id.*, p. 102.)

Neither the Commissioner nor FPIC is a party to Endorsement No. 3. *Id.*, Exhibit 4H; Chao Decl., Exhibit 5 at p. 46, ¶ 30.

In July 2004, Frontier made an initial petition to the Rehabilitation Court for approval of Endorsement No. 3. Chao Decl., Exhibit 2 at pp. 9-23; Exhibit 5 at p. 46, ¶ 31. On April 4, 2005, Frontier renewed its petition to approve Endorsement No. 3. *Id.*, Exhibit 5 at p. 46, ¶ 34; Exhibit 3 at pp. 24-32. Frontier represented to the Rehabilitation Court *inter alia* that Frontier would receive $45 million in cash and $145 million of debt relief and that Frontier could not be rehabilitated without the $45 million infusion of cash. *Id.*, Exhibit 3 at pp. 25-27, ¶¶ 5, 7; Exhibit 5 at p. 46, ¶¶ 34-35. NICO did not object to or otherwise controvert the representations made by Frontier and on July 28, 2005, the Rehabilitation Court approved Endorsement No. 3. *Id.*, Exhibit 4 at pp. 33-38; Exhibit 5 at p. 46, ¶ 36.

D. NICO Claims It is Unable to Pay Covered Losses Due FPIC

Throughout FPIC's liquidation, the Commissioner worked with Frontier and NICO to reconcile loss data, and report and collect on reinsurance recoverables. This was necessary since all of the accounts and records were commingled and in the possession of Frontier at its principal office located in New York. Roberts Decl., ¶ 14.

In January 2005, the Commissioner submitted a billing to NICO for payment of FPIC's claims under the NICO Agreement. *Id*., ¶ 15. In June 2005, during the course of meetings with Frontier and NICO, the Commissioner agreed that he would await the Rehabilitation Court's approval of Endorsement No. 3 before re-billing NICO for FPIC's losses. *Id.* Neal Conolly, the designated agent of Frontier, represented to the Commissioner that once Endorsement No. 3 was approved by the New York rehabilitation court, FPIC would be able to collect the reinsurance receivables due from NICO. *Id*.

On or about September 20, 2005, after receipt of the order approving Endorsement No. 3, Frontier submitted FPIC's reinsurance losses in the principal amount of $4,883,090 to NICO for payment. *Id*., ¶ 16. NICO, however, refused to pay based on the terms of Endorsement No. 3. It claimed that under Paragraph 9 of Endorsement No. 3, only Frontier can make the unilateral decision on whether to release FPIC from such liability. *Id.*, ¶ 17. Most recently, NICO asserted again that unless Frontier instructs otherwise, FPIC was now liable for the $40 million in liability incurred by Frontier and which NICO forgave as to Frontier. *Id.* Frontier in turn has proposed that it would direct NICO to release FPIC from Frontier's $40 million liability on the condition that FPIC waive all inter-company balances between Frontier and FPIC, including a $19 million owed by Frontier to FPIC. *Id*., ¶ 18.

Faced with NICO's reliance on Endorsement No. 3 to not pay FPIC without Frontier's instruction, and the inability to collect reinsurance funds to distribute to CIGA to pay policy claims and to wind up the estate, the Commissioner filed a complaint in the Superior Court of the State of California for the County of San Diego seeking declaratory relief as to the effect of Endorsement No. 3 on the FPIC liquidation estate. NICO removed this action to this Court and now seeks to stay this action pending arbitration. NICO contends that the Commissioner is bound by the arbitration clauses under the reinsurance agreements to arbitrate Endorsement No. 3. The Commissioner, however, is not a signatory to Endorsement No. 3 and thus cannot be compelled to arbitrate disputes concerning Endorsement No. 3.

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III.

ARGUMENT

A. The Commissioner Is Not A Party To Endorsement No. 3 And Thus Cannot Be Compelled To Arbitrate Any Dispute Arising From That Agreement.

It is a cardinal rule that an arbitration clause cannot be enforced against a party who has not agreed to arbitrate. The United States Supreme Court has long recognized that "arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit." *United Steelworkers of Am. v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 582, 80 S. Ct. 1347, 4 L.Ed.2d 1409 (1960); *see AT&T Technologies, Inc. v. Communications Workers of Am.*, 475 U.S. 643, 648, 106 S. Ct. 1415, 89 L.Ed.2d 648 (1986) (reiterating the principles established in *United Steelworkers*). The threshold question of whether an arbitration agreement exists between the parties must be decided by the court. *AT&T Technologies, Inc.*, 475 U.S. at 652; *Three Valleys Muni. Water Dist. v. E.F. Hutton & Co.*, 925 F.2d 1136, 1041 (9th Cir. 1991).

The Ninth Circuit follows the doctrine that in general non-parties are not bound to arbitrate a dispute unless an arbitration agreement exists.[5] *See Comedy Club, Inc. v. Improv West Assocs.*, 514 F.3d 833, 844-845 (9th Cir. 2007); *Comer v. Micor, Inc.*, 436 F.3d 1098 (9th Cir. 2006). Thus, the Court must first find that a valid agreement to arbitrate the dispute exists in order to require Commissioner to arbitrate under Endorsement No. 3. *See* 9 U.S.C. § 4; *Lowden v. T-Mobile USA, Inc.*, 512 F.3d 1213, 1217 (9th Cir. 2008). If the Court finds that no agreement exists to require the Commissioner to arbitrate, it then must determine if the Commissioner must still arbitrate as a nonsignatory under the ordinary contract principles of 1) incorporation by reference, 2) assumption, 3) agency, 4) veil piercing/alter ego, and 5) estoppel as well as third party beneficiaries. *Comer v. Micor, Inc.*, 436 F.3d at 1101.

Further, the Federal Arbitration Act's liberal policy in favor of arbitration concerns only

[5] California case law is in accord. The California Supreme Court has held that "'the policy favoring arbitration cannot displace the necessity for a voluntary *agreement* to arbitrate.'" *Victoria v. Superior Court (Kaiser Foundation Hospitals)*, 40 Cal.3d 734, 739 (1985).

"'the scope of arbitrable issues.'" *Comer v. Micor, Inc.*, 436 F.3d at 1104 n.11 (citing *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25, 103 S. Ct. 927, 74 L.Ed.2d 765 (1983)). This policy "does not apply to the determination of whether there is a valid agreement to arbitrate between the parties; instead '[o]rdinary contract principles determine who is bound.'" *Id.*; *see Chastain v. Union Security Life Ins. Co.*, 502 F. Supp. 2d 1072, 1075 n.2 (C.D. Cal. 2007) (finding that court not bound by the liberal policy in favor of arbitration to determine that no valid arbitration agreement existed).

1. The Dispute Is Limited to Endorsement No. 3.

The Commissioner is not bound to arbitrate disputes concerning Endorsement No. 3 because he is not a party to that agreement. NICO does not dispute this fact. Instead, NICO's request to stay this case pending arbitration does not address the threshold question of whether a valid arbitration agreement between it and the Commissioner exists or whether the arbitration clause can be invoked to compel the Commissioner to arbitrate the meaning of an agreement to which he is not a party. It simply assumes that the arbitration provisions contained in the Centre Re Agreements and the NICO Agreement are applicable. (Motion, pp. 7:22-8:1.) NICO primarily relies on the federal policy in favor of arbitration and its presumption that the dispute is within the scope of arbitration. (Motion, pp. 8-13.) None of those arguments, however, address the question of whether the Commissioner is required to arbitrate disputes under Endorsement No. 3, and the underlying question of the legal effects of NICO waiving its right to offset the $40 million owed to it by Frontier, releasing Frontier of its obligation to pay NICO $40 million, as well as paying an additional $50 million to Frontier upon the New York Rehabilitation Court's approval of Endorsement No. 3.

NICO's bald assertion that the "Commissioner effectively seeks to recover reinsurance balances that have accrued" is untenable, especially since NICO relies on Endorsement No. 3 as the basis of its inability to pay FPIC's claims. The relief sought by the Commissioner is limited to the legal effect of Endorsement No. 3. The Commissioner seeks declarations that (1) FPIC is not bound by any obligations that Frontier and NICO attempt to impose on it pursuant to Endorsement No. 3; (2) Endorsement No. 3 had the effect of satisfying any obligation of FPIC or

Frontier to NICO for outstanding premiums; and (3) NICO's attempt to setoff additional premium incurred by Frontier and waived by NICO against FPIC pursuant to Endorsement No. 3 violates California Insurance Code section 1031. The circumstances here are thus distinguishable from *Bennett v. Liberty National Fire Insurance Co.*, 968 F.2d 969, 971-972 (9th Cir. 1992), and *Quackenbush v. Allstate Insurance Co.*, 121 F.3d 1372, 1380 (9th Cir. 1997), where the liquidator sought to enforce contractual rights under the reinsurance agreements.

The fact that Endorsement No. 3 implicates underlying obligations under the reinsurance agreements does not make the arbitration clauses in those agreements binding on this dispute. In *E.I. DuPont de Nemours and Co. v. Rhone Poulenc Fiber & Resin Intermediates, S.A.S.*, 269 F.3d 187 (3d Cir. 2001), the Third Circuit rejected just such an argument. In that case, a subsidiary of DuPont entered into a joint venture agreement ("Agreement") that contained an arbitration agreement. While DuPont was not a party to the agreement, the Agreement stated that DuPont would provide certain assistance to the joint venture. DuPont also entered into several related agreements with the joint venture company. *Id.* at 191-192. When the joint venture failed, DuPont filed an action against another joint venturer, Rhodia Fiber, and its parent, Rhodia, not for breach of the Agreement, but for breach of an oral agreement and fraudulent misrepresentations that occurred much later. The district court refused to compel arbitration under the Agreement.

In affirming, the Third Circuit recognized that the Agreement contained a valid arbitration agreement, but found that DuPont was not a signatory to the Agreement and also not bound to arbitrate under traditional contract principles. *Id.* at 194. The court further considered that some of DuPont's claims against the subsidiary arise in part from the underlying Agreement and whether DuPont should be estopped from repudiating the Agreement. *Id.* at 200. However, the Court found that because DuPont alleged a separate oral agreement, the core of the case was the conduct of defendants with respect to the later agreement, and not the breach of the Agreement. *Id.* at 201.

Similarly, the Commissioner has not alleged any breach of the reinsurance agreements. The core dispute in this case pertains to NICO's conduct with respect to Endorsement No. 3 to pay Frontier $50 million (¶ 7), to release Frontier from repayment of $140 million NICO loan

balance (¶ 8) and as part of NICO's forgiveness of the $140 million to agree not to collect from Frontier the $40 million funds held balance (¶ 9) thereby waiving all of its rights to offset against the obligations incurred by Frontier all to the purported detriment of FPIC. *See* Casaccio Decl., Exhibit 4H at p. 99. Neither FPIC nor the Commissioner is a party to this agreement. Thus, the fact that the reinsurance agreements contain arbitration clauses does not compel the Commissioner to arbitrate this separate dispute concerning Endorsement No. 3.

2. No Contractual Principles Require the Commissioner to Arbitrate Disputes Concerning Endorsement No. 3.

The Commissioner cannot be forced to arbitrate his claims under any contractual principles regarding the legal effect of Endorsement No. 3 and NICO's release of Frontier of its obligations to pay premium obligations. The court in *Zurich American Insurance Co. v. Watts Industries, Inc.*, 417 F.3d 682 (7th Cir. 2005), refused such a request by an insurer to compel a subsidiary to arbitrate a dispute based on an agreement between the insurer and the parent company. In that case, both Watts Industries, Inc. (Watts) and its subsidiary, James Jones Company (Jones) were named insureds under liability policies issued by Zurich. Watts also entered into several separate deductible agreements with Zurich, but Jones did not. The deductible agreement provided that the named insureds under the liability policies shall be jointly and severally responsible for the obligations under the deductible agreement. *Id.* at 687. The liability policies did not contain any arbitration clauses, but the deductible agreements did. *Id.* at 684. When Watts and Jones were sued in two cases in California, they tendered the claims to Zurich, which refused to provide coverage. Watts and Jones each filed suit against Zurich for defense and indemnity under the liability policies. Zurich in turn filed a petition to compel arbitration in Illinois federal court against both parties. *Id.* at 685.

In refusing to compel Jones to arbitrate, the Seventh Circuit found that the deductible agreements' language to include named insured did not evidence any agreement by Jones to arbitrate its dispute with Zurich. There was no argument that Jones attempted to assume any obligations under the deductible agreements or that those agreements were incorporated by reference into the liability policies. *Id.* at 687. The Court found that the existence of parent and

subsidiary relationship itself did not create any alter ego or agency relationship so as to bind Jones. Finally, Zurich failed to show that Jones received any *direct* benefit from the deductible agreements, and Jones has not sought to enforce any rights under the deductible agreements. *Id.* at 688.

Similarly, the principles of incorporation by reference, assumption, agency, veil piercing/alter ego, estoppel, and third party beneficiary do not apply in this case.

First, Endorsement No. 3 is a separate agreement entered into by Frontier and NICO that binds only Frontier and NICO. The fact that it is appended to the NICO Agreement does not mean that all of terms of the Endorsement No. 3 are incorporated into the NICO Agreement with respect to FPIC. In fact, Article 11 of the NICO Agreement prohibits any amendment without FPIC's consent. Here, FPIC is not a party to Endorsement No. 3, and thus did not provide its written consent to the incorporation of the NICO Agreement into Endorsement No. 3 or vice versa. Thus, NICO and Frontier's agreement did not make the Commissioner's dispute with NICO subject to the arbitration clause.

Second, "a party may be bound by an arbitration clause if its subsequent conduct indicates that it is assuming the obligation to arbitrate." *Thomson-CSF, S.A. v. American Arbitration Ass'n*, 64 F.3d 773, 777 (2d Cir. 1995). There is no claim that FPIC took any action to assume Endorsement No. 3.

Third, NICO has not claimed that Frontier acted as an agent of FPIC in executing Endorsement No. 3. Indeed, the Liquidation Order specifically enjoins any person from interfering with FPIC's assets and the Commissioner's management of those assets. Roberts Decl., Exhibit A at pp. 11-13, ¶¶ 25, 29.

Fourth, the close relationship of a parent and its subsidiary may in some circumstances justify piercing the corporate veil. *Thomson-CSF*, 64 F.3d at 777. However, as Frontier and FPIC are under orders of rehabilitation and liquidation, respectively, there is no question that Frontier could not act as an alter ego of FPIC.

Fifth, "[e]quitable estoppel 'precludes a party from claiming the benefits of a contract while simultaneously attempting to avoid the burdens that contract imposes.'" *Comer v. Micor,*

Inc., 436 F.3d at 1101 (citation omitted). While a nonsignatory may be estopped from avoiding arbitration if it "'knowingly exploited the agreement containing the arbitration clause despite having never signed the agreement,'" there is no assertion that FPIC exploited Endorsement No. 3 for its benefit. *Id.* (citing *DuPont*, 269 F.3d at 199).

Finally, neither the Commissioner nor FPIC is a third party beneficiary of Endorsement No. 3. A signatory may enforce an arbitration agreement against a third party beneficiary if the contract "reflects the express or implied intention of the parties to the contract to benefit the third party." As NICO contends that FPIC is now liable for Frontier's $40 million debt that NICO forgave Frontier of under Endorsement No. 3, there is clearly no intent, express or implied, under Endorsement No. 3 to benefit FPIC. Rather Endorsement No. 3 is designed to burden FPIC with $40 million in liability incurred by Frontier that NICO had an absolute right to offset against its obligations to Frontier but elected to waive instead. *See* Casaccio Decl., Exhibit 4A at p. 44, Article XI.[6]

Thus, none of the contractual principles compel the Commissioner to arbitrate his dispute with NICO under Endorsement No. 3.

B. The Liquidation Order Bars NICO From Compelling Arbitration.

NICO incorrectly interprets the injunctions under the Liquidation Order as asserting over *in rem* jurisdiction that does not prohibit any award of declaratory relief by arbitration. The Liquidation Order contains a number of injunctions staying actions taken against the Commissioner that not only affect the assets of the insolvent insurer, but also interfere with the Commissioner's management of the liquidation.

Further, California Insurance Code section 1020 specifically empowers this Court to issue the injunctive orders set forth in the Liquidation Order to preclude litigation against the insolvent estate in part as follows, requires that upon the issuance of an order either under California Insurance Code section 1011 or 1016, or at any time thereafter, the court shall issue such other

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6. Article XI(A), provides in part that "[i]n consideration of the Reinsurer agreeing to the Funds Withheld provision, the Company agrees the Fund Withheld Balance may be **set off by the Reinsurer against liability of any nature whatsoever**…." (Emphasis added.)

injunctions or orders as may be deemed necessary to prevent any or all of the following occurrences:

> (a) Interference with the commissioner or the proceeding.
> (b) Waste of assets of such person.
> **(c) The institution or prosecution of any actions or proceedings.**
> (d) The obtaining of preferences, judgments, attachments, or other liens against such person or its assets.
> (e) The making of any levy against any such person or its assets....

(Emphasis added.)

The Legislature determined that, as a matter of vital public policy, once the conservation and liquidation orders were issued it was essential that the assets of the insurance company be conserved and not depleted. Section 1020 thus "reflects a legislative intent to preserve an insolvent insurer's assets for orderly disposition by the commissioner." *Webster v. Superior Court*, 46 Cal.3d 338, 344 (1988) (permitting relief from stay for personal injury action to be filed against insolvent insurer when plaintiff does not seek recovery against insolvent insurer's assets). Accordingly, the injunctive orders in the Liquidation Order are statutorily mandated to ensure the orderly distribution of estate assets and to prevent waste.

The specific injunctions set forth in Section 1020 reverse preempt the Federal Arbitration Act pursuant to the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015, which provides that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance … unless such Act specifically relates to the business of insurance…." 15 U.S.C. § 1012(b).

In *United States v. Fabe*, 508 U.S. 491, 501-502, 113 S. Ct. 2202 (1993), the United States Supreme Court set forth the following three-part test to determine whether McCarran-Ferguson Act should be applied to reverse preempt federal law: (1) whether the federal statute at issue "specifically relate to the business of insurance"; (2) whether the state statute enacted "for the purpose of regulating the business of insurance"; and (3) whether the application of the federal statute would "impair, interfere, or supercede" the state statute. The Ninth Circuit has determined that under *Fabe*, a reinsurer such as NICO could not invoke an arbitration clause to compel arbitration of its claims against an insolvent insurer. *See Quackenbush v. Allstate Ins.*

Co., 121 F.3d at 1381. Courts in other jurisdictions applying the test under *Fabe* have similarly found that state insolvency statute's stay of litigation reverse preempted the FAA so as to bar reinsurers from compelling the liquidator to arbitrate. *See Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277 (10th Cir. 1998) (finding that Utah insurance insolvency statutes reverse preempted the FAA); *Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585, 590-596 (5th Cir. 1998) (finding same under Oklahoma insurance insolvency statutes).

NICO's attempt to compel the Commissioner to arbitrate without his consent would violate Section 1020 and the Liquidation Order irrespective of whether the relief sought is monetary or equitable. Section 1020 bars all actions and does not distinguish between actions for damages from actions for equity. It also reverse preempts the FAA to the extent it requires arbitration of any dispute.

Thus, NICO is barred from requiring the Commissioner to arbitrate this dispute when the Commissioner has not agreed to do so.

C. Arbitration Of This Dispute Is Not Appropriate.

While reinsurance arbitration may be appropriate in some circumstances, requiring the Commissioner to arbitrate this dispute over Endorsement No. 3 is not appropriate in this case for several reasons. First, this is not a usual reinsurance dispute concerning specialized accounting or reinsurance coverage that would require expertise in the reinsurance industry. This is a dispute over the legal effect of third party contracts that attempts to release a party of its $40 million debt and bind an insolvent insurance company solely to its detriment. It also involves insolvency law.

Further, any purported advantages of arbitration disappear when applied to an insolvent reinsured. Arbitration is expensive. *See* Graydon S. Staring, Law of Reinsurance § 21:1 (2008). The parties must pay for their party arbitrator as well as a neutral and pay all related facility expenses, travel expenses and lodging. NICO also asserts that the seat of the arbitration panel must be in New York, thus requiring the Commissioner to potentially retain New York counsel, and bring witnesses to New York. FPIC is already in a deficit of over $8.5 million. Requiring the estate to expend precious funds to pay arbitrators and related arbitrations expenses is an inordinate waste of estate assets and against the public interests. Every dollar that is spent to pay

arbitrators and the associated expenses of arbitration is one dollar less to pay the policyholders and other creditors of FPIC. In turn, the people of the State of California must pay more to cover the losses that are not paid by the FPIC's estate as a result of NICO and Frontier's attempt to shore up their own assets.[7]

Arbitration is also not expeditious. NICO and Frontier's concerted action to have FPIC shoulder the burdens of Frontier's rehabilitation by way of Endorsement No. 3 has already delayed the Commissioner's ability to wind up the FPIC's estate. The Commissioner has completed almost all tasks with respect to FPIC. His inability to collect the reinsurance proceeds from NICO because of NICO's reliance on Endorsement No. 3 is a significant obstacle to the Commissioner's closing of the estate.

Thus, the Commissioner should not be required to arbitrate the effect of Endorsement No. 3 where arbitration would be a waste of estate assets and time consuming.

D. Stay Is Not Warranted For Non-Arbitrable Claims.

Even if the Court finds that only some of the Commissioner's claims are non-arbitrable, the Court may sever the arbitrable and non-arbitrable claims, and stay this action only as to the arbitrable claims. The United States Supreme Court has specifically approved the bifurcation of arbitrable and non-arbitration causes of actions as follows: "The preeminent concern of Congress in passing the [Arbitration] Act was to enforce private agreements ... and that concern requires that we rigorously enforce agreements to arbitrate, even if the result is 'piecemeal' litigation...." *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221, 105 S. Ct. 1538 (1985).

Therefore, the Court should not stay the non-arbitrable claims the Commissioner has asserted against NICO.

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[7] Post-liquidation policyholder claims made against FPIC are paid by the estate, or if a "covered claim," paid by CIGA. Cal. Ins. Code §§1033, 1063.1 and 1063.2. CIGA pays all "covered claims" up to $500,000. Cal. Ins. Code § 1063.1(c). CIGA in turn has a claim against the assets of FPIC for the amount of policyholder claims it pays on behalf of FPIC. Cal. Ins. Code § 1033(a)(2) (providing that CIGA claims are Class 2 after expense of administration). To the extent FPIC's assets are insufficient to pay all covered claims and all other policyholder claims, CIGA must pay them out of its reserves, which are derived from an assessment on each insurance policy issued in California. Cal. Ins. Code § 1063.5.

IV.

CONCLUSION

Based on the foregoing, the Commissioner respectfully requests that the Court deny the motion to stay this action pending arbitration of claims because the Commissioner is not a party to Endorsement No. 3 and has not agreed to arbitrate his claims with NICO.

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